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Emerging Economies Business Cycles: The Role of Commodity Terms of Trade News

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Abstract

Recent empirical work has challenged the hypothesis that terms-of-trade shocks are an important source of cyclical fluctuations in emerging economies. We show that ignoring the news component in the terms-of-trade movements results in misleading conclusions about their importance as a source of cyclical fluctuations. Using a sample of Latin American countries, we identify news-augmented Commodity-terms-of-trade (CTOT) shocks by maximizing the forecast error variance share of the CTOT series at a finite future horizon. Our identification does not rely on zero impact restrictions typically used in the literature for recovering news shocks. Accounting for news almost doubles the contribution of CTOT to explain cyclical fluctuations: news-augmented CTOT shocks explain almost half of output variations in emerging economies.

Keywords: commodity terms of trade, business cycles, news shocks, maximum forecast error variance, small open economy.

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